

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ERNEST Z. AND SHOSHANA R. FELD)

Appearances:

For Appellants: Ernest Z. Feld, in pro. per.
For Respondent: Timothy W. Boyer
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Ernest Z. and Shoshana R. Feld against proposed assessments of additional personal income tax in the amounts of \$331.87 and \$234.41 for the years 1970 and 1971, respectively.

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Ernest Z. Feld (hereinafter referred to as appellant) owned and operated a bakery in Berkeley, California from 1961 through 1964. As part of that business, appellant produced frozen pastry products which he packaged in material supplied by the Unger Paper Company (hereinafter referred to as Unger). In 1964, appellant experienced a loss of profits, and related damages as a result of alleged defects in the packaging material supplied by Unger. Consequently, appellant filed suit against Unger. In 1970, appellant received a net recovery of \$11,438.75 pursuant to an out of court settlement, of the lawsuit.

In 1965, appellant permanently closed the Berkeley bakery and purchased a similar business in Oakland, California. Due to certain lease obligations, however, appellant continued to pay rent and other expenses associated with the closed bakery from 1965 until 1970. Appellant sold or assigned his interest in the Berkeley bakery and its equipment in 1970.

On his joint California personal income tax return for 1970, appellant claimed a \$25,005.00 net loss from the Berkeley business. In computing that amount, appellant subtracted the \$11,438.75 settlement payment from \$36,443.75 of claimed business losses which appellant considered attributable to the packaging material supplied by Unger. Appellant applied a portion of the net loss as a deduction from his 1970 gross income, and treated the balance as a net operating loss carryover to reduce his 1971 income tax liability.

After conducting an audit of appellant's 1970 and 1971 returns, respondent, correctly determined that appellant was not entitled to carry forward a net business loss from 1970 to 1971. Respondent also determined that appellant was entitled to deduct in 1970 only \$9,315.00 for losses incurred in connection with the Berkeley business. On the basis of those determinations, respondent issued the proposed assessments for the years 1970 and 1971. Subsequent to respondent's audit, appellant changed his position with respect to the tax treatment of the settlement payment. Appellant now contends that the payment is excludable from his 1970 gross income as damages received on account of injury to his reputation and health. Thus, if-is

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appellant's position that no amount of the settlement payment should be applied to offset any allowable losses from the Berkeley business. Also, although appellant initially agreed with respondent's action in disallowing most of the deductions reported on the 1970 return for losses sustained in connection with the Berkeley bakery, appellant now contends that he is entitled to deductions for such losses in the total amount of **\$36,443.75.**

Subsequent to the filing of this appeal, appellant conceded the propriety of respondent's action in disallowing the net operating loss carryover claimed on appellant's 1971 return. Accordingly, the issues presented for our resolution are: (1) whether the **\$11,438.75** payment received by appellant in 1970 in settlement of his lawsuit against Unger is excludable from gross income as damages received on account of personal injuries; and (2) ~~whether~~ respondent properly disallowed certain deductions claimed by appellant for losses incurred in connection with his Berkeley bakery.

Section 17138 of the Revenue and Taxation Code specifically excludes from the definition of gross income "any damages received (whether by suit or agreement) on account of personal injuries." However, the taxability of the proceeds of a lawsuit, or of a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery. (Carter's Estate v. Commissioner, 298 **F.2d** 192, 194 (8th Cir.), cert. denied, 370 U.S. 910 [8 L. Ed. 2d 404] (1962); Dudley G. Seay, 58 T.C. 32, 36 (1972); Appeal of Gogi Grant Rifkind, Cal. St. Bd. of Equal., May 10, 1966.) Furthermore, respondent's determination regarding the nature of the payment in question is presumed to be correct, and the burden rests with appellant to establish that the settlement payment received from Unger represents damages received on account of personal injuries. (See Sager Glove Corp. v. Commissioner, 311 **F.2d** 210 (7th Cir. 1962), cert. denied, 373 U.S. 910 [10 L. Ed. 2d 411] (1963); Appeal of Gogi Grant Rifkind, supra.)

The evidence contained in the record on appeal does not conclusively establish the precise nature of appellant's claim against Unger. The record does not contain a copy of the complaint filed against Unger, nor does it contain

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any evidence of the terms and provisions of the settlement agreement. However; the record does contain evidence which indicates that the primary purpose for the lawsuit was the recovery of profits lost by appellant due to the allegedly defective Packaging material supplied by Unger. On the basis of that evidence, respondent concluded that the settlement payment was made to compensate appellant for lost profits, and, therefore, that the payment constituted ordinary income. (Appeal of Gogi Grant Rifkind, supra.) Since appellant has failed to present sufficient evidence, to show that respondent's conclusion is erroneous, we have no alternative but to conclude that appellant has failed to sustain his burden of establishing that the \$11,438.75 settlement payment was excludable from his gross income.

The next issue for determination involves . . . deductions in the total amount of \$36,443.75 claimed by appellant on his 1970 return for losses purportedly incurred in connection with the Berkeley bakery. The record indicates that such losses consist of: (1) \$9,315.00, representing expenses and losses incurred by appellant relative to the maintenance and sale of the Berkeley bakery and equipment subsequent to 1965; (2) \$9,128.75, representing expenses incurred by appellant during 1964 for the development and promotion of an experimental frozen pastry product, and (3) \$18,000.00, representing the asserted value of the time and labor appellant expended in developing the experimental product. Apparently, it is appellant's position that the above, items constitute losses or damages caused by the alleged defective packaging material supplied by Unger.

It is well settled that deductions are a matter of legislative grace and the burden of proving the right thereto is upon the taxpayer. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Robert J. and Evelyn A. Johnston, Cal. St. Bd. of Equal., April 22, 1975.) Moreover, a taxpayer seeking a particular deduction must be able to specify an applicable statute and establish that the deduction comes within its terms. (Appeal of Benjamin F. and Sue S. Kosdon, Cal. St. Bd. of Equal., May 4, 1976.)

With respect to the first category of the above described deductions, the record indicates that respondent has allowed all of the items contained therein. Therefore, our concern is with the last two categories of

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deductions. It is our opinion that appellant has failed to sustain his burden of proving his entitlement to the deductions included in those categories. Specifically, the expenses incurred by appellant in connection with the development and promotion of the experimental pastry product are not deductible in 1970 because they represent Operational expenses which were properly deductible in a previous year. The asserted value of appellant's time and labor expended in developing the experimental pastry product, on the other hand, is not deductible because the Revenue and Taxation Code contains no provision for the deduction of such expenses. Accordingly, we must sustain respondent's action in disallowing the deductions in question.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Ernest 2. and Shoshana R. Feld against proposed assessments in the amounts of \$331.87 and \$234.41 for the years 1970 and 1971, **respectively**, be and the same **is** hereby sustained.

Done at Sacramento, California, this 2nd day of March, 1977, by the State Board of Equalization.

Shirley G. Brandt, Chairman
George J. [unclear], Member
Philip [unclear], Member.
_____, Member
_____, Member

ATTEST: W. W. [unclear], Executive Secretary